



PART 1

Sustained, High Growth in the Postwar Period

What Is Growth?

Gross domestic product (GDP) is a familiar but remarkable statistic. It is an astonishing feat of statistical compression, reducing the restless endeavor and bewildering variety of a national economy into a single number, which can increase over time. China's GDP grew by 11.9 percent in 2007, America's may not grow at all in 2008. Both of those terse statistical statements sum up world-changing developments, which will attract vast volumes of commentary and explanation. Few other statistics in the social sciences are as expressive.

A growing GDP is evidence of a society getting its collective act together. As its economy grows, a society becomes more tightly organized, more densely interwoven. A growing economy is one in which energies are better directed; resources better deployed; techniques mastered, then advanced. It is not just about making money.

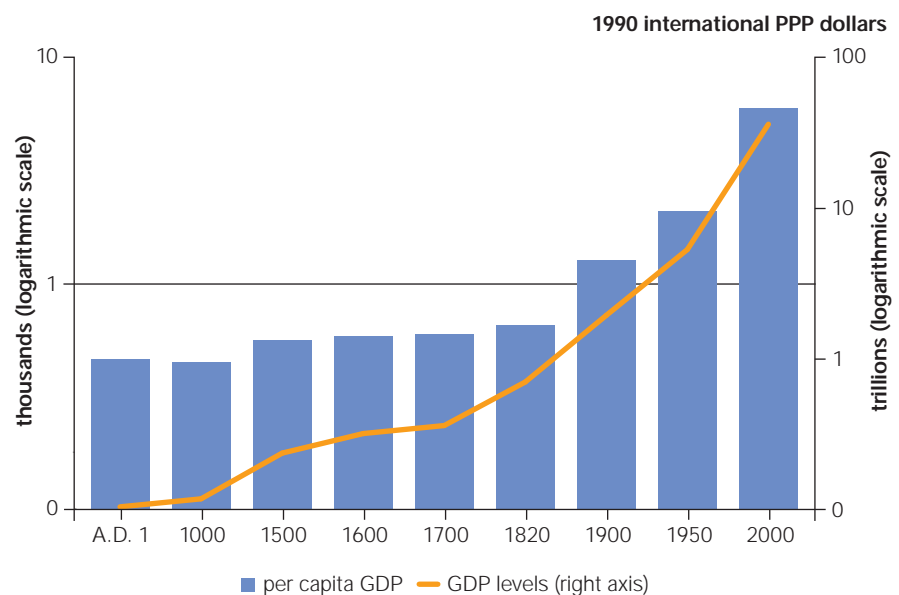
Economic growth is a recent phenomenon in human history. It began with the industrial revolution in Britain at the end of the 18th century. "It is impossible to contemplate the progress of manufactures in Great Britain within the last thirty years without wonder and astonishment," wrote Patrick Colquhoun, a Scottish merchant, in 1814. This progress spread to Europe and North America in the 19th century, accelerating as it traveled. In the 20th century, particularly in the second half, it spread and accelerated again.

Mr. Colquhoun attributed the progress he saw to “ingenious machinery, invigorated by capital and skill.” Today’s economists account for growth with much the same triple formula of technology, capital, and human capital. But these are only the proximate causes of growth. Its deeper roots draw on advances in science, finance, trade, education, medicine, public health, and government, to name but a few of the factors in play.

Over the past two centuries, what we now call the global economy has expanded in fits and starts. Interrupted by the slump of the 1930s, it was rebuilt in the 1940s, when the institutional foundations of today’s world economy (the General Agreement on Tariffs and Trade, the precursor of the World Trade Organization; the International Monetary Fund; the World Bank; and the United Nations and its diverse agencies) were laid. Globalization has since proceeded apace, aided by legislation (the lowering of tariffs and quotas and the relaxation of capital controls) and innovation (the declining cost of transport and communication).

This renaissance of the world economy helps to explain an uptick in world growth since the latter half of the 20th century (see figure 1). As the world economy has opened and integrated, technology and know-how have flowed more easily to developing countries. Latecomers can assimilate new techniques much more quickly than the pioneering economies can invent them. That is why poorer countries can “catch up” with richer ones.

Figure 1 Evolution of Global and Per Capita GDP in the Last 2,000 Years



Source: Maddison, Angus. 2007. *Contours of the World Economy, 1–2030 AD*. Oxford, UK: Oxford University Press.

Note: PPP = purchasing power parity.

The lessons that countries import are not only technological. Both China and then India reformed their closed, heavily regulated economies, motivated in part by the force of international example. These epic *voltes face* also help to explain why global growth has increased in recent decades. It was probably no harder to reverse the policies of India and China than to reform the policies of Mauritius and Vietnam. But political breakthroughs in vast places benefit a much greater proportion of the globe.

This accelerating growth has created new challenges. The first is a clear divergence in incomes within and between countries. Of the roughly 6 billion people on the planet, about 65 percent live in high-income or high-growth economies, up from less than a fifth 30 years ago. The remaining 2 billion people live in countries with stagnating, or even declining, incomes. The world population is projected to increase by 3 billion people by 2050. Unfortunately, 2 billion of this extra population will live in countries that are currently enjoying little or no growth. Thus, if these trends persist, the proportion of the world population living in low-growth environments might increase.

The second challenge is environmental. The quickened growth of world GDP has put new pressure on the planet's ecology and climate. This strain may ultimately threaten the growth environment of the last 200 years.² If an economy fails to grow, man's efforts to better himself become a scramble for a bigger share of a fixed amount of resources. Ecological stress quickly becomes social and political. Some of these pressures and their implications are discussed in part 4 of the report.

The 13 Success Stories

As a point of departure we review the cases of high, sustained growth in the postwar period. Thirteen economies qualify: Botswana; Brazil; China; Hong Kong, China; Indonesia; Japan; the Republic of Korea; Malaysia; Malta; Oman; Singapore; Taiwan, China; and Thailand. Two other countries, India and Vietnam, may be on their way to joining this group. It is to be hoped other countries will emerge soon.

These cases demonstrate that fast, sustained growth is possible—after all, 13 economies have achieved it. They also show that it is not easy—after all, *only* 13 economies have ever done it. Indeed, some people view these cases as “economic miracles,” events impossible to explain and unlikely to be repeated. This report takes exception to that view. There is much to learn from outliers. Paul Romer, a leading growth theorist and a member

² See Martin Wolf on the possibility of returning to the zero-sum environment that characterized the pre-growth period, with the attendant risks of conflict. Wolf, Martin. 2007. “The Dangers of Living in a Zero-Sum World Economy.” *The Financial Times*, December 19.

of the Commission's working group, reminds us that when Japan grew at this pace, commentators said it was a special case propelled by postwar recovery. When the four East Asian tigers (Hong Kong, China; Taiwan, China; Singapore; and Korea) matched it, skeptics said it was only possible because they were so small. When China surpassed them, people said it was only because China was so big.

In truth, the sample is remarkably diverse (see table 1). The familiar Asian examples may dominate the list, but every other region of the developing world (Africa, Latin America, the Middle East, and emerging Europe) is also represented. Some of the countries are rich in natural resources (Botswana, Brazil, Indonesia, Malaysia, Oman, Thailand); the remainder are not. The sample includes one country with a population well over 1 billion (China), and another with a population well below 500,000 (Malta).

Perhaps more intriguing is how differently the success stories end. Six of the economies (Hong Kong, China; Japan; Korea; Malta; Singapore; and Taiwan, China) continued to grow all the way to high-income levels. But several of the others lost some or all of their growth momentum long before catching the leading economies. The most striking example is Brazil, where fast economic growth petered out around the time of the second oil shock in 1979 and has yet to resume (see box 2).

The 13 economies each, then, have their idiosyncrasies. But it would be wrong to conclude that they defy generalization, or that there is no point in learning about their growth paths because the lessons cannot be applied at home. That was not the attitude the countries themselves took. Policy mak-

Table 1 13 Success Stories of Sustained, High Growth

Economy	Period of high growth**	Per capita income at the beginning and 2005***	
Botswana	1960–2005	210	3,800
Brazil	1950–1980	960	4,000
China	1961–2005	105	1,400
Hong Kong, China*	1960–1997	3,100	29,900
Indonesia	1966–1997	200	900
Japan*	1950–1983	3,500	39,600
Korea, Rep. of*	1960–2001	1,100	13,200
Malaysia	1967–1997	790	4,400
Malta*	1963–1994	1,100	9,600
Oman	1960–1999	950	9,000
Singapore*	1967–2002	2,200	25,400
Taiwan, China*	1965–2002	1,500	16,400
Thailand	1960–1997	330	2,400

Source: World Bank, World Development Indicators.

*Economies that have reached industrialized countries' per capita income levels.

**Period in which GDP growth was 7 percent per year or more.

***In constant US\$ of 2000.

Box 2: Brazil's slowdown

Brazil was one of the first countries to achieve sustained, high growth (its run began in 1950) and the first to lose its momentum (in 1980). At first glance, Brazil's case sits uneasily beside the other 12 on our list. Unlike those countries, it is best known for a strategy of "import substitution," sheltering its domestic industries so they could compete for the home market against foreign rivals.

During its first phase of import substitution, however, Brazil in fact succeeded in diversifying its exports, branching out from coffee into light manufacturing with the help of foreign direct investment. Exports as a percentage of GDP more than doubled from 5 percent in the early-1950s to about 12 percent in the early 1980s, even as coffee's share of exports fell dramatically. Brazil also had the twin advantages of a sizable domestic market and abundant agricultural resources. These two endowments allowed it to reach very high growth

rates despite a modest engagement with the world economy.

Why did it slow down? The causes are hard to disentangle, just as the slowdown has been hard to reverse. Brazil's problems began after the first oil shock in 1973, which left the country suffering from inflation and an overhang of debt. In response, the government in 1974 turned further inward. It began a "second phase" of import substitution, which went beyond light manufacturing to promote heavy industries and capital goods production, a strategy that was heavily dependent on the recycling of petrodollars. When dollar interest rates spiked after 1979, Brazil plunged into a debt and high-inflation crisis from which it took more than a decade to emerge. In the process, Brazil's exports declined from 12 percent of GDP in the early 1980s to 6 percent in the mid-1990s, losing nearly all of the ground they had gained in the high-growth period.

ers learned by example; case studies had a pronounced influence; demonstration effects were surprisingly important. It is said that Deng Xiaoping was strongly influenced by his first encounters with Singapore and New York City, on a visit to the United Nations.

A close look at the 13 cases reveals five striking points of resemblance (see figure 2):

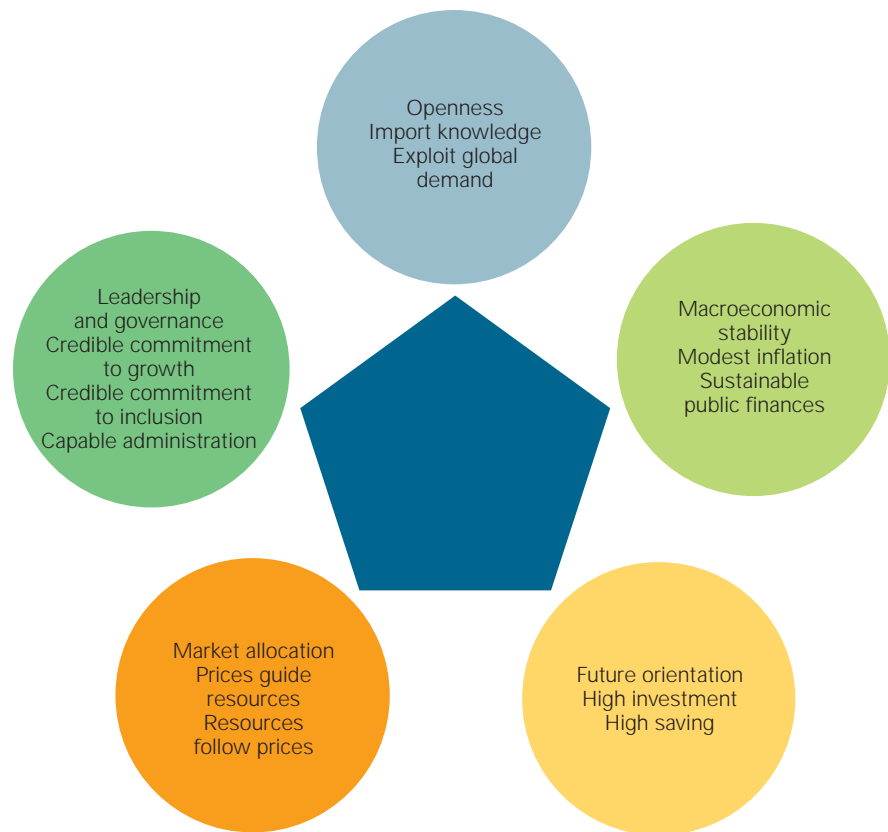
1. They fully exploited the world economy
2. They maintained macroeconomic stability
3. They mustered high rates of saving and investment
4. They let markets allocate resources
5. They had committed, credible, and capable governments

1. The global economy

During their periods of fast growth, these 13 economies all made the most of the global economy. This is their most important shared characteristic and the central lesson of this report. Sustained growth at this pace was not possible before 1950. It became feasible only because the world economy became more open and more tightly integrated.³ The global economy is still

³ As Barry Bosworth of the Brookings Institution has noted, this opening is not just about cutting tariffs, but also about expanding the range of goods that can be traded and included in multilateral trade negotiations.

Figure 2 The Common Characteristics of High, Sustained Growth



a work in progress, of course, but its effects have already been dramatic. Properly exploited for the benefit of all citizens, it is one of the most powerful weapons against poverty.

The high-growth countries benefited in two ways. One, they imported ideas, technology, and know-how from the rest of the world. Two, they exploited global demand, which provided a deep, elastic market for their goods. The inflow of knowledge dramatically increased the economy's productive potential; the global market provided the demand necessary to fulfill it. To put it very simply, they imported what the rest of the world knew, and exported what it wanted.

Knowledge

It is easier to learn something than it is to invent it. That is why advanced economies do not grow (and cannot grow) at rates of 7 percent or more, and why lagging economies can catch up. To take an early example: the textiles industry of Osaka eclipsed the mills of Lancashire by borrowing,

assimilating, and improving British designs and techniques. The façade of the Osaka Spinning Company, established in 1883, was even built from imported Lancashire red brick.⁴

There are many channels through which knowledge can pass to a developing economy. One is foreign direct investment (FDI). Malaysia, for example, has attracted multinationals to its three electronics clusters—in Penang, the Klang Valley, and Johore—where they enjoy tax holidays and other privileges.⁵ Multinationals bring production technologies, an understanding of the global market, and an ability to manage international supply chains. Japan and Korea were historically much less open to FDI, but they did import and improve upon technology from outside. Japan's Sony, for example, surpassed America's RCA in the market for small radios, using technology it had licensed from the American company itself.

Demand

The global economy also provides a large, relatively stable market for the goods of developing countries. In the 1950s, some economists fell prey to “export pessimism.” They assumed that the more goods the developing world sold on global markets, the lower the price they would fetch. This thesis may or may not have been true for primary products and commodities. But it did not hold for the manufactured goods in which many of our 13 success stories developed a comparative advantage. In most cases, their potential output was small relative to the size of the world market.⁶ This gave them scope to specialize, raise productivity dramatically, and expand their output manifold. The four tigers, for example, increased their manufactured exports from \$4.6 billion (in 2000 dollars) in 1962 to \$715 billion in 2004. If there was any small decline in price, it was overwhelmed by the vigorous growth in sales.

This is one reason why inward-looking growth strategies quickly falter. Domestic demand is no substitute for this expansive global market. In a poor country, the home market is small and therefore relatively “inelastic.” For sales to rise, prices have to fall. Size is not the only problem. The pattern of domestic spending may not correspond well to the strengths of domestic supply. What home consumers want to buy may not match what home producers are best at making. Since specialization is limited by the extent of the market, home markets give an economy less scope to specialize in its areas of comparative advantage.

“In the 1950s Korea pursued a policy of import substitution. Growth was only 2–3 percent. But in the early 1960s, Korea totally changed to an outward-oriented strategy, emphasizing trade. This jump-started our growth to over 7 percent, sustained over a long period.”

—Han Duck-soo

4 Saxonhouse, Gary. 1974. “A Tale of Japanese Technological Diffusion in the Meiji Period.” *The Journal of Economic History* 34 (1): 149–65.

5 Yusof, Zainal Aznam, and Bhattasali, Deepak. 2007. “Economic Growth and Development in Malaysia: Policy Making and Leadership.” Case Study, Commission on Growth and Development.

6 Two exceptions may be China in manufacturing and India in services.

“The three “dos” for growth that I care most about in the report are economic openness, social inclusiveness, and effective governments. The message can be spelled out equally well in three “don’ts”: inwardness, exclusion, and bloated governments—a recipe for stagnation.”

—Edmar Bacha

2. Macroeconomic stability

Macroeconomic volatility and unpredictability damage private sector investment, and hence, growth. During their most successful periods, the 13 high-growth cases avoided the worst of this turbulence.

Their quick expansion was accompanied, from time to time, by moderately high inflation. Korea, for example, had double-digit inflation rates for most of the 1970s; China’s inflation peaked at about 24 percent in 1994. But prices were stable enough not to scramble market signals, cloud the view of long-term investors, or deter savers from entrusting their wealth to banks.

Governments were also fiscally responsible. Many ran budget deficits for extended periods; some nursed high ratios of debt to GDP. But this public debt did not get out of hand, not least because the economy grew faster than the stock of public liabilities.

3. Future orientation

This macroeconomic stability set the stage for their third characteristic: they all mustered high rates of saving and investment, not least public investment in infrastructure. They were all “future-oriented,” forgoing consumption in the present in pursuit of a higher level of income in the future.

In the mid-1970s, Southeast Asia and Latin America had similar savings rates. Twenty years later, the Asian rate was about 20 percentage points higher. China has saved more than a third of its national income every year for the past 25 years. This saving has been accompanied by prodigious rates of domestic investment.

In a paper written for the Commission, Peter Montiel of Williams College and Luis Servén of the World Bank catalog some of the possible reasons for East Asia’s thrift.⁷ The region benefited from favorable demography. With fewer dependents to take care of, working-age adults had more scope to put money aside. Macroeconomic stability also helped. Thailand’s saving rate rose quickly in the 1980s, for example, thanks to tighter government budgets. As mentioned, these countries also mostly avoided high and unpredictable inflation, which arbitrarily redistributes wealth from savers to debtors and discourages people from holding financial assets.

Some countries employed more direct measures to enforce thrift. In 1955, Singapore established a mandatory saving scheme, the Central Provident Fund, which collects contributions from wages that are primarily saved until retirement, although some withdrawals for medical and housing have been permitted. Malaysia has a similar system. Both countries, as well as Japan and Korea, also had postal saving systems, which catered to the needs of small savers. Their financial systems were, by contrast, less ready

⁷ Montiel, Peter, and Servén, Luis. 2008. “Real Exchange Rates, Saving, and Growth: Is There a Link?” Background Paper, Commission on Growth and Development.

to extend consumer credit. By making it harder to borrow, they may have made it easier to save.

4. Market allocation

The 20th century saw many experiments with alternatives to markets. They were all conclusive failures. It therefore seems safe to say that markets are a necessary part of the economic structure in order to achieve and sustain growth.

The high-growth economies all relied on a functioning market system, which provided price signals, decentralized decision making, and incentives to supply whatever was in demand. Countries varied in the strength and clarity of their property rights. But in all cases, firms and entrepreneurs felt they had enough of a claim on their assets to invest heavily in them.

In Hong Kong, China, the administration was famously *laissez faire*. Other governments in our list were more hands-on, intervening with tax breaks, subsidized credit, directed lending and other such measures. These interventions may have helped them to discover their comparative advantage—revealing how best to deploy their endowments of labor and capital. But they did not defy their comparative advantage, as Justin Yifu Lin, the chief economist of the World Bank, has put it. This distinction is conceptually subtle, but economically consequential.

An economy's endowment of labor, natural resources, and capital dictates its comparative advantage. But this mandate is very broad. The crowded, coastal economies of East Asia, for example, had a comparative advantage in labor-intensive manufacturing. But what line of labor-intensive manufacturing, precisely? Using what techniques? Those answers they had to discover for themselves through trial and error. This process of "self-discovery" may have been helped along by the government's hand.⁸ What was not helpful were government efforts to promote heavy industry, before accumulating the capital required to make it viable.

Resource mobility and structural transformation

A country's comparative advantage will evolve over time. In any period of fast growth, capital, and especially, labor moves rapidly from sector to sector, industry to industry. This mobility of resources was a feature of all the 13 high-growth cases. Governments did not resist (although they may have tempered) the market forces that pulled people into the urban areas or destroyed some jobs, while creating others. In Malaysia, for example, agriculture's share of employment fell from 40 percent in 1975 to about 15 percent in 2000. Only a quarter of Malaysia's people lived in cities in 1957, the year of its independence; by 2005, 63 percent did. Even in China, where

"Government provides the environment for growth, but it is the private sector that invests and creates wealth for the people."

—Goh Chok Tong

⁸ Hausmann, Ricardo, and Rodrik, Dani. 2003. "Economic Development as Self-Discovery." *Journal of Development Economics* 72: 603–33.

the household registration system placed some restrictions on mobility, vast shifts of population have taken place.

Economies do not grow smoothly and evenly, maintaining their shape as they increase their size. Instead, fast-growing economies go through a tumultuous process of creative destruction, breaking into new industries even as they abandon their traditional industrial strongholds. The challenge that each of the 13 governments faced was how to shield people from the worst of this tumult, without retarding the economy in the process.

5. Leadership and governance

Growth is about more than economics. It also requires committed, credible, and capable governments. “[I]n the long run it does not pay to build an economic mansion on a foundation of political sand,” writes Benjamin Mkapa, former president of Tanzania, in a paper written for the Commission.⁹ The high-growth economies typically built their prosperity on sturdy political foundations.

Their policy makers understood that growth does not just happen. It must be consciously chosen as an overarching goal by a country’s leadership. In Singapore, for example, the pursuit of growth has served as an organizing principle of the country’s politics for the past 40 years, according to a recent speech by Senior Minister Goh Chok Tong, a member of the Commission. The government and other institutions have constantly sought to anticipate the actions required to sustain the economy’s momentum.

Does that make Singapore unusual? After all, most political leaders advertise their commitment to economic development. But in their choices, if not their words, many governments prize political tranquility over the economic upheaval that growth can entail. Others carry out plausible economic reforms for their own sake. If growth does not ensue, they do not experiment with something else; they simply declare victory and go home.

In the fast-growing economies, by contrast, policy makers understood that successful development entails a decades-long commitment, and a fundamental bargain between the present and the future. Even at very high growth rates of 7–10 percent it takes decades for a country to make the leap from low to relatively high incomes (see figure 3).

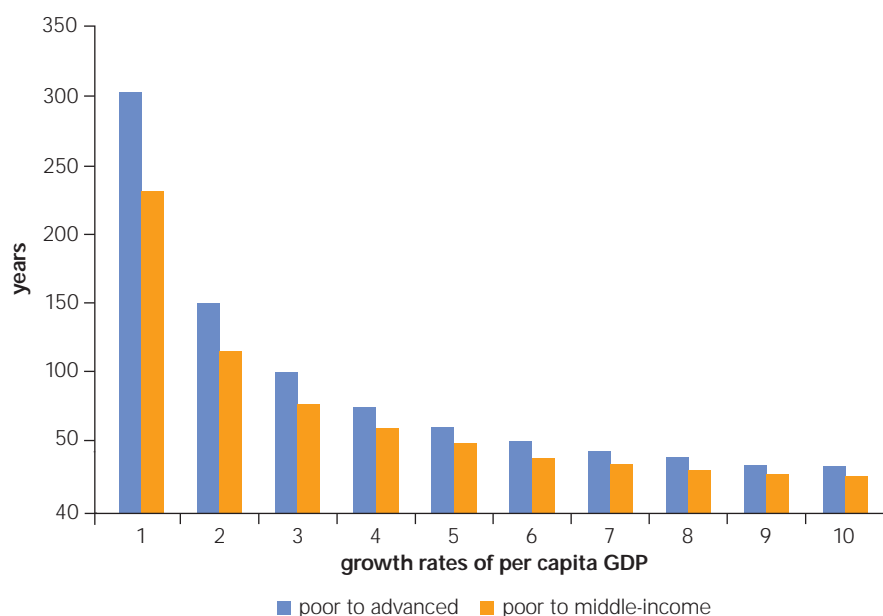
During this long period of transition, citizens must forgo consumption today in return for higher standards of living tomorrow. This bargain will be accepted only if the country’s policy makers communicate a credible vision of the future and a strategy for getting there. They must be trusted as stewards of the economy and their promises of future rewards must be believed.

“I think leadership matters, but I don’t mean just the top leader. I think you also need a team that knows what the right policies are and has the skills, or is able to contract the skills, to help implement those policies.”

—Ngozi N. Okonjo-Iweala

⁹ Mkapa, Benjamin. 2007. “Leadership for Growth, Development and Poverty Reduction: An African Viewpoint and Experience.” Case Study, Commission on Growth and Development.

Figure 3 Transitions to Higher Incomes



Their promise must also be inclusive, leaving citizens confident that they and their children will share in the benefits. In Botswana, for example, Seretse Khama handed over diamond mining rights from his own tribe to the government, which gave every tribe in Botswana a bigger stake in the state's success.¹⁰ Other governments forged an implicit or explicit social contract in support of growth, offering health, education, and sometimes redistribution. These contracts were kept, if not in detail, then at least in spirit. Absent this kind of political foundation, sustaining the policies that promote growth is very difficult if not impossible.

Such leadership requires patience and a long planning horizon. In several cases, fast-growing economies were overseen by a single-party government that could expect to remain in power for decades to come. In a multiparty democracy, on the other hand, governments typically look no further than the next election. But democracies can nonetheless preside over remarkable passages of growth. Today's India is the most prominent example. But Ireland and Australia also provide some instructive lessons.

Australia's Productivity Commission was established by an act of parliament in 1998, although it can trace its roots back 30 years. An independent state agency, it regularly evaluates government regulations and microeconomic policies, analyzes Australia's long-term growth prospects, and helps bring people together to craft proposals for reform. The Irish Social Partnership, which arose out of the country's economic stagnation in the 1980s,

“Reforms can be costly—they can withdraw from the political capital of governments. So after some achievements, governments may start to relax or enjoy the status quo. But what matters is sustainable efforts, not the ups and downs or ons and offs of reforms.”

—Mahmoud Mohieldin

10 Acemoglu, Daron, and Robinson, James. 2007. “The Role of Institutions in Growth and Development.” Background Paper, Commission on Growth and Development.

brings employers, unions, and the government together every three years to rethink and renegotiate the nation's economic strategy. Once these deliberations are ratified, they become the framework for policy making for the next three years.

These latter cases show that democracies can be surprisingly farsighted. Rival political parties can, for example, agree on a bipartisan growth strategy, which they each promise to follow when it is their turn in power. Even if a formal pact is never made, a successful growth strategy, commanding the confidence of the public, may outlast the government that introduced it.

Committed to the goal of high growth, governments should be pragmatic in their pursuit of it. The policy makers who succeeded in sustaining high growth were prepared to try, fail, and learn. Singapore, for example, did not turn outward until it had first tried turning inward, encouraging domestic firms to compete with industrial imports. In China, Deng Xiaoping reportedly described his approach as crossing the river by feeling for the stones—an oft-repeated phrase in China.

The Art of Policy Making

It is relatively easy to identify the shared characteristics of the high-growth cases and easy to appreciate their collective importance. But it is hard to know how to replicate these characteristics. Some of them are the outcome of innumerable decisions and interactions by firms, households, and offi-

Box 3: Reform teams

The business of “feeling for the stones” in fast-growing economies was often carried out by highly qualified technocrats in small, dedicated “reform teams”^a. Singapore had its Economic Development Board, Korea its Economic Planning Board, and Japan its Ministry of Trade and Industry.

Reform teams were not burdened with administrative duties, but they were given direct access to the top of the government. Malaysia's Economic Planning Unit reported directly to the prime minister. Taiwan, China's Council for U.S. Aid, which began in 1948 and evolved into the Council for Economic Planning and Development, reported directly to the president. Indeed, several future heads of government sprang from their ranks: the second chairman of the Council later became president of the country.

From this unique position—ensconced in the government, but distanced from day-to-day administrative burdens and immediate political demands^b—the reform teams helped coordinate the government's efforts and overcome administrative opposition and inertia.

Although technocrats unchecked by political forces can fail to balance economic with political and social concerns, political forces unchecked by technocratic knowledge can be disruptive.

a. Criscuolo, Alberto, and Palmade, Vincent. 2008. “Reform Teams: How the Most Successful Reformers Organized Themselves.” Public Policy for the Private Sector Note 318, World Bank, Washington, DC.

b. Evans, Peter. 1995. *Embedded Autonomy: States and Industrial Transformation*. Princeton, NJ: Princeton University Press.

cial. Some are the result of evolution, not design. None is a straightforward policy.

For example, the success stories show that high, sustained growth requires an impressive saving rate. But what should governments do to promote thrift? Should they restrict credit, mandate saving, or raise taxes? The historical record shows that growth requires broadly stable prices, a currency that is not debauched by hyperinflation. But does that mean the central bank should be made formally independent? It is also clear that successful economies learned quickly from the rest of the world, assimilating new techniques. But how can policy makers help an economy to learn?

In the context of a developed country, economists prescribe policies with some measure of confidence. Some advisers offer prescriptions to poorer countries with the same level of conviction. They argue that developing economies are just like advanced economies, only poorer.

But in recent decades, economists have acquired a deeper appreciation of the underlying institutions that make mature markets work. These institutions define property rights, enforce contracts, convey information, and bridge informational gaps between buyers and sellers. These institutions and capabilities may not be fully formed in a developing economy. Indeed, the immaturity of these institutions is synonymous with underdevelopment. That makes it harder to predict how an economy will respond to, say, the removal of a tariff or the sale of a public asset.

Uncertain about how to model developing economies, we also suspect that the correct model changes over time. A fast-growing economy is a moving target. Often markets and institutions co-evolve, responding to the constraints and the demands one places on the other. Land registries, for example, emerge only after land becomes scarce. Accountancy evolves as and when the capital markets demand it.

This makes life doubly difficult for policy makers. It is hard to know how the economy will respond to a policy, and the right answer in the present moment may not apply in the future. Today's bad policies are often yesterday's good policies, applied for too long. Governing a growing economy is not a static challenge. It is more akin to a long voyage undertaken with incomplete and sometimes inaccurate charts.¹¹

The Role of Government

What then should governments do? What is the optimal size of the state and what are its proper responsibilities? More ink has been spilled on that question than any other in development. It is a recurring theme of this report and the debates that preceded it.

“Markets and governments work differently at different stages of development—their structure, their functions, their goals all change. There are phases in which governments substitute for markets and phases in which market institutions develop.”

—Zhou Xiaochuan

¹¹ Four decades ago, independent Singapore embarked on an uncertain journey. Unemployment was high, industry nonexistent, and the future looked bleak. Prime Minister Lee Kuan Yew wrote of that day, “I started out with great trepidation on a journey along an unmarked road to an unknown destination.”

One response is to argue that governments should do as little as possible. “That government is best which governs least,” as the motto goes. Fifteen years ago, much of the discussion of government shared this presumption in favor of smaller government and freer markets. Its policy conclusions are captured in the phrase: “Stabilize, privatize, and liberalize.”

While there is some merit in what lies behind this prescription, it is an extremely incomplete statement of the problem. It is true that bloated government should not crowd out the private sector; regulation should not be excessive; the economy should be open to trade and competition; and private investors should be free to earn a remunerative return. The injunction to roll back the state was also motivated in part by concerns about the motivation and competence of government. If government’s role is defined too broadly, it may not have the capacity to perform such an expansive array of functions. Or it may misuse its broader mandate, pursuing goals other than growth and widespread prosperity, such as the welfare of vested interests.

But our view of effective government is somewhat different. The issues of competence and motivation cannot be dismissed. But they cannot be answered by simply writing government out of the script. Our model of developing economies is too primitive at this stage to make it wise to pre-define what governments should do. Numerous country case studies suggest that its role evolves over time as its own capabilities and those of the private sector mature. Our motto then would follow Sir Arthur Lewis, the great development economist, who observed that “[G]overnments may fail either because they do too little, or because they do too much.”¹²

Some countries, for example, suffer from too little public investment; others, from too much government regulation. Some suffer from both problems simultaneously. In India, for example, the first priority in the 1990s was for the government to do less, dismantling the excesses of the license-and-permit Raj. Now the government is trying to do more, making up for years of underinvestment in public infrastructure.¹³

A preoccupation with the size of government can also distract attention from its effectiveness. History is littered with instructive examples. After the Great Depression, economists came to understand that America’s fledgling central bank made the slump much worse. They could have argued for sharply limiting the powers and activities of the central bank, and some did. But others focused on how to help central banks do their job more effectively: how to free them from harmful political constraints, establish their credibility, and improve their tools and techniques. To us, this second approach seems more promising in developing countries. The task is to

“If I were to make a provocative statement, I would say that the prevalence of the first-best, optimal policy approach, which implies an excess of orthodoxy, leads to sub-optimal growth performance. That’s a pretty strong statement.”

—Alejandro Foxley

¹² Lewis, Arthur. 1955. *The Theory of Economic Growth*. London: George Allen & Unwin.

¹³ See Montek Singh Ahluwalia (the Deputy Chairman of India’s Planning Commission and a member of the Commission) in an interview in *The McKinsey Quarterly*, October 2007.

improve the effectiveness of government institutions rather than stripping them of their tasks.

It seems to us that the correct response to uncertainty is not paralysis but experiment. Governments should not do nothing, out of a fear of failure. They should test policies, and be quick to learn from failure. If they suffer a misstep, they should try something else, not plunge ahead or retreat to the shore.

These experiments should, however, be cautious. Each step should be weighed to generate the greatest amount of information about the economy for the least cost, should the policy prove to be a misstep. When they choose policies, governments should ask themselves, what is the worst that could happen? Small experiments are usually less damaging, should they fail, than big ones. Risk management is an important aspect of policy formation in developing countries.

China offers examples of such cautious policy making. Its initial reforms in 1978 freed farmers to sell any surplus produce, over and above government production quotas, on the open market. They responded much as microeconomic theory would predict. Prices rose, farm output soared, and farmers' lives improved. On the other hand, Chinese reformers have been careful not to copy macroeconomic policies from advanced economies. They knew that the economy early in the reform period would not respond to macroeconomic variables, like interest rates, in the way predicted by advanced country models.

Some question this deliberate, step-by-step gradualism. In some cases, "bad times make good policies." Crises, which can upset the stable configuration of political forces, sometimes provide an opening to implement major reform packages that would otherwise be blocked. However, there are possibly as many examples of crises leading to bad choices, as there are cases of crises leading to good ones. In short, crises may remove obstacles to a sound growth strategy, but they cannot ensure that a sound strategy will indeed be chosen. In this context, leadership and influential and enlightened technocrats play an enormously important role.

“Pragmatism and gradualism are different. In Indonesia, reforms have been pragmatic, willing to accommodate political and social reality. But they have not been gradual. When the economy was growing well, complacency set in. It was only when fortunes reversed that the reformers were able to move, and then they had to move quickly.”

—Dr. Boediono